Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-205-00
YMPeters

date: FEB 25 2000

to: Donna Suarez, Appeals Officer
Laguna Niguel

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted] - **I.R.C. § 1001**
Tax Year: [redacted]

DISCLOSURE LIMITATIONS

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ISSUES

Whether the taxpayer realized taxable income when its debt was amended to add an obligor and to change collateral and when upon default, its creditor stated its intention not to enforce the note until the taxpayer paid another obligation in exchange for the taxpayer's agreement not to use the statute of limitations as a defense to collection.

CONCLUSIONS

The alterations to the taxpayer's note are not significant modifications because they did not affect the taxpayer's ability to pay on the note and were not economically significant. The note was not deferred for the tax year at issue. It also was not forgiven but continues to be legally enforceable for the original amount.

FACTS

Our advice is contingent on the accuracy of the information that Appeals has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

In [redacted], [redacted] ([redacted]), a second tier subsidiary of the taxpayer, [redacted] ([redacted])[1], entered into a stock purchase agreement with [redacted] to acquire all stock of [redacted] ([redacted]), a subsidiary of [redacted]. [redacted].

The [redacted] and [redacted] facilities are located on [redacted] acres of a [redacted] acre site collectively referred to as the "[redacted]." [redacted]'s assets included the [redacted] (of [redacted] acres) and several residences located near the [redacted].

To purchase [redacted]'s stock, [redacted] paid $[redacted] in cash and issued a $[redacted] recourse promissory note to [redacted]. [redacted] dollars of this note is secured. The collateral consists of individual real estate mortgages on the [redacted] land and improvements and the [redacted], including land known as [redacted]. Additional collateral included all machinery and equipment used at [redacted] and the [redacted] including all additions and replacements and all of the conversion services contracts. The debt was entered on the books of [redacted]. Both [redacted] and [redacted] signed the note. According to the taxpayer, it was intended that [redacted] act as guarantor.

Interest on the note was based on the [redacted] London Interbank Offered Rate on specified days plus [redacted]. Interest payments commenced [redacted]. The first of [redacted] equal quarterly principal installments was to be paid [redacted]

The acquisition of [redacted] was treated as a stock purchase. The assets of [redacted] retained a carryover basis for tax depreciation, which exceeded the purchase price of the stock.

In [redacted], [redacted]'s [redacted] activities were divided from its [redacted] operations through an I.R.C. § 351 transfer. The original [redacted] retained the [redacted] business and changed its name to [redacted] ([redacted]). Simultaneously, [redacted] established a subsidiary called [redacted] ([redacted]), to own and operate the [redacted] business. The [redacted] also signed the note, becoming a guarantor on the note, jointly and severally liable

[1] Now [redacted].

with [redacted] and [redacted].

In [redacted], the [redacted] shut down the [redacted] for procedural violations. The shut down lasted [redacted]. Due to the losses resulting from the shut down, [redacted] decided to enter into a partnership with [redacted] ([redacted]). [redacted] also owns a [redacted] facility. Through this partnership, called [redacted], [redacted] and [redacted] would jointly provide conversion services utilizing only one plant, with the other plant to be maintained in standby mode. The parties agreed to put the [redacted] in standby mode and, instead, operate the [redacted] facility. [redacted]/[redacted] would receive "standby revenues" from the partnership. This agreement was signed [redacted].

As part of the partnership negotiations, [redacted] attempted to restructure the [redacted] note. On [redacted], [redacted] signed a release of the security interest in the conversion contracts and in return received a substitute security interest in the "standby revenues." No other changes were made at that time.

On [redacted], another violation took place at the [redacted]. [redacted] All production was shut down, the facility was evacuated and an investigation begun. The plant was not restarted and a plan was submitted to the [redacted] in [redacted] for [redacted] the [redacted]. A full [redacted] is highly expensive. In [redacted], the [redacted] issued an order seeking to hold [redacted] ([redacted])[2] and [redacted]/[redacted]/[redacted] responsible for funding the costs of [redacted] reclamation at [redacted]'s facility and directed the companies to provide financial assurance in the amount of $[redacted]. [redacted], [redacted] and [redacted] did not have the resources to pay for [redacted]'s [redacted] and pay [redacted]'s note. [redacted] suggested to [redacted] that its best available alternative was to allow [redacted] to use the money saved by not repaying [redacted] on the note for site clean up. [redacted] rejected this proposal.

During [redacted], [redacted] sold plant equipment to various corporations.[3] Remaining assets, including the entire [redacted] conversion facility, its buildings and equipment, were abandoned although some office space was continued to be used in [redacted]'s administration of the [redacted] of the facility. [redacted] reported the amount of gain on the items sold on its [redacted] return. It also claimed losses on its [redacted] return for assets which were abandoned and for spare parts. The abandoned assets were part of the security for the loan. According to the taxpayer, the value in [redacted] of the remaining collateral exceeded the principal and interest due on the note as of [redacted].

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[2] [redacted] is the first tier subsidiary under [redacted]. It is the parent corporation of [redacted].

[3] These appear to be part of the assets securing the note. The facts do not indicate whether [redacted] gave permission for these assets to be sold.

[redacted] paid the [redacted] interest but did not pay the principal installment due on the same day. On [redacted], [redacted] sent a Notice of Default. In a letter dated [redacted], [redacted] focused on three conditions:

1. [redacted] demonstrate that the restructuring of the debt was necessary to the groups' financial viability, including its ability to remediate the [redacted] properties;

2. [redacted]/[redacted] reach an agreement with the [redacted] on the terms of a [redacted]/funding plan; and

3. The restructuring in no way impair [redacted]'s comprehensive environmental indemnification of [redacted] under the [redacted] guarantee (a condition set forth in the [redacted] purchase agreement of [redacted]'s stock).

The parties were not able to reach agreement on restructuring the note and discussions were suspended until [redacted] when [redacted] defaulted on its interest payment. On [redacted], [redacted] and the [redacted] companies affirmed that they would agree to waive any statute-of-limitation defenses to claims arising from failure to make payments on the [redacted] note and would provide [redacted] with financial statements on a timely and regular basis.

From [redacted] through [redacted], [redacted] and [redacted] were in litigation with the [redacted] regarding their responsibility to fund [redacted]. Concern was expressed that [redacted]'s funds could be plundered by creditors leaving [redacted] without funds to complete [redacted].

In a letter dated [redacted], [redacted] notified [redacted] that it would respond to these concerns by declaring its intention to continue non-payment of the principal and interest on the note until all [redacted] obligations were satisfied (which is expected to occur in [redacted]). On [redacted], [redacted] provided a letter stating its *intent* to defer taking legal action under the note until the completion of [redacted]. In providing this letter, [redacted] required that the [redacted] companies and [redacted] sign a Tolling Agreement waiving the statute of limitations as a defense to collection. This, however, is only a letter of intent, leaving [redacted] free to take legal action at any time. The due date of the note was not extended, interest was not waived but continues to accrue and the note was not subordinated to any other interest. [redacted] continues to send statements of interest and principal to [redacted] and [redacted] sends [redacted] its financial statements.

The examining agent proposes to increase the taxpayer's income for the tax year [redacted] by $[redacted], the amount of the [redacted] note. He asserts that the debt is no longer a debt and should therefore be taken into income. He argues that the debt was "transformed through material modifications."

DISCUSSION

The Internal Revenue Code defers tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. I.R.C. § 1001(a); Cottage Savings Association v. Commissioner, 499 U.S. 554, 559 (1991). In order to "realize" a gain or loss, the taxpayer must engage in a "sale or other disposition of property." I.R.C. § 1001(a). An exchange of property can be a realization event under I.R.C. § 1001(a) but only if the properties exchanged are "materially different." Cottage Savings, 499 U.S. at 566. Materially different means the exchanged properties "embody legally distinct entitlements." Id. In Cottage Savings, 499 U.S. 554, the Court held that the exchange of mortgage interests between savings and loan companies was material because the underlying mortgages represented different legal entitlements.

In 1996, the Treasury Department issued Treasury Regulation § 1.1001-3 to be used to determine whether a modification of a debt instrument results in an exchange for purposes of I.R.C. § 1001. Significant modifications of the terms of a debt instrument may result in a deemed exchange of the old debt for the "new" modified debt. Treas. Reg. § 1.1001-3(b). Treasury Regulation § 1.1001-3 applies to alterations of terms of a debt instrument on or after September 24, 1996. These regulations may be relied upon by taxpayers, however, for alterations between December 2, 1992 and September 24, 1996. Treas. Reg. § 1.1001-3(h).

The alterations to [redacted]'s debt instrument consist of the following:

1. In [redacted], [redacted] was added as a signatory of the note, intended as a guarantor.

2. In [redacted], [redacted] signed an agreement releasing the security interest in the conversion contract and substituting a security agreement in the "standby revenues."

3. In [redacted], [redacted] sold certain assets securing the debt and abandoned certain others.

4. In [redacted], [redacted] and the [redacted] companies affirmed that they would agree not to use the statute of limitations as a defense to collection under the note and that they would provide [redacted] with financial statements on a regular and timely basis. A tolling agreement was signed in [redacted].

5. In [redacted], [redacted] provided [redacted] and the [redacted] companies a letter of intent not to take legal action on the note until the completion of [redacted]. This letter does not extend the due date of the note.

These changes all occurred prior to [redacted]. In evaluating these alterations the Regulations are useful in establishing the Service position, even for transactions taking place prior to [redacted]. Cases addressing the modification of debt instruments are limited. They tend to apply, however, a facts and circumstances test based on an analysis of the overall transaction rather than viewing any single factor as determinative. See, e.g., Cottage Savings, 499 U.S. 554; Mutual Loan and Savings Co. v. Commissioner, 184 F.2d 161 (1950). The Regulations analyze exchanges based upon particular types of alterations. The changes must meet two thresholds, modifications and significant modifications in order for the changes to lead to a deemed exchange of a debt instrument for a new debt instrument. Treas. Reg. § 1.1001-3(b).

Modifications

A modification is "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." Treas. Reg. § 1.1001-3(c)(1)(i). An agreement to change a term of a debt instrument is a modification at the time the parties enter into the agreement, even if the change is not immediately effective. Treas. Reg. § 1.1001-3(c)(6). For example, the addition of a co-obligor is a modification. Treas. Reg. § 1.1001-3(c)(2)(i). Adding [redacted] to the note is a modification. The change of security and sale or abandonment of secured property are also modifications because they affect the legal rights of [redacted]. Similarly, an agreement to forgo the use of the statute of limitations as a defense is a modification because it changes a legal right.

In contrast, failure to perform generally is not a modification. Treas. Reg. § 1.1001-3(c)(4)(i). [redacted] failed to pay principal and interest as required by the note. This failure of itself, however, is not a modification. A holder's temporary forbearance is a modification once "the forbearance remains in effect for a period that exceeds (A) Two years following the issuer's initial failure to perform; and (B) Any additional period during which the parties conduct good faith negotiations...." Treas. Reg. § 1.1001-3(c)(4)(ii). Here, [redacted] has not taken action under the note and likely will not take action until [redacted] is completed in approximately [redacted][4] As of the tax year [redacted], however, the default had taken place less than two years prior and the parties were still negotiating. [redacted]'s forbearance at that time would not yet be a modification.

Significance of the Modification

In order to be deemed an exchange of a note for a new note, the modification must be significant. "A modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." Treas. Reg. § 1.1001-3(e)(1). Specific rules applicable to the following situations supercede this general rule, however. Id.

(a) Changing an obligor

[redacted] was added as a signatory on the note. The substitution of an obligor on a recourse debt instrument is a significant modification unless the new obligor acquires substantially all of

[4] [redacted] may take action prior to [redacted], however.

the assets of the original obligor and the transaction does not result in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(i)(A) and (C). [5]

A change in payment expectation occurs if, as a result of a transaction, there is substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument. This occurs where an obligor's ability to meet payment obligations was primarily speculative prior to the modification and is adequate after the modifications. It also occurs where there is a substantial impairment of the obligor's ability to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification. Treas. Reg. § 1.1001-3(e)(4)(vi)(A). The obligor's ability to meet payment obligations includes any source for payment including collateral, guarantees or other credit enhancement. Treas. Reg. § 1.1001-3(e)(4)(vi)(B).

Since [redacted] was a new subsidiary which acquired a portion of the assets of the original obligor, who was still liable on the note, and there was no change in payment expectations from this change, this alteration is not a significant modification.

(b) Changes of Collateral

Similarly, a modification of a recourse debt instrument which releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement is a significant modification if the modification results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(iv)(A). The first change in collateral was the substitution of "standby payments" for conversion contracts. The second was the sale of certain secured assets and the abandonment of certain others. These assets were all associated with the [redacted] plant. Prior to the modification [redacted]'s capacity to meet the payment obligations under the note was primarily speculative. It had been attempting to restructure the note since the first plant shut down in [redacted]. It defaulted on the note in [redacted]. The changes in collateral took place in [redacted] and [redacted]. After the changes its ability to meet payment obligations was still primarily speculative. Therefore, the changes in collateral are not significant modifications.[6]

(c) Changes in the timing of payments.

Changes in the timing of payments are a significant modification if they result in the material deferral of scheduled payments. The materiality of deferral depends on all the facts and circumstances, including the length of deferral, the original term of the instrument, the amounts

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[5] This is essentially the rule for changes in guarantors, which is how the taxpayer states they intended the change. This rule is discussed below as part of changes in collateral.

[6] In addition, considering that the value of the remaining assets securing the debt exceed the principal and interest due, the change lacks economic significance.

of the payments that are deferred, and the time period between the modification and the actual deferral of payments. Treas. Reg. § 1.1001-3(e)(3)(i). A safe harbor period is set forth in the Treasury Regulations. The safe harbor period begins on the original due date of the first scheduled payment that is deferred and extends for the lesser of five years or 50% of the original term of the instrument. Treas. Reg. § 1.1001-3(e)(3)(ii).

Here the first payment of principal was due on [redacted]. No payment of principal was made. The taxpayer continued to make payments of interest until [redacted] when it also began defaulting on interest payments. In [redacted], [redacted] stated its intent not to enforce the note until after the [redacted] is completed. Although this is only a statement of intent, it is a modification because it is evidenced by the letter and by the conduct of the parties. Treas. Reg. § 1.1001-3(c)(1)(i). It is not clear when the deferral of payments actually commenced, however, because this is not an agreement to defer. It is simply a statement of intent not to enforce after the taxpayer defaulted. [redacted] could choose to enforce the note at any time. For the tax year at issue, [redacted], there was not yet a significant change in the timing of the payments.

The changes to [redacted]'s debt are not economically significant. Interest is continuing to accrue on the principal. Also, [redacted] maintains its rights to enforce the note because the taxpayer signed the tolling agreement agreeing not to raise the statute of limitations as a defense. Finally, the note was not truly deferred. [redacted] defaulted and [redacted], rather than writing-off the note as a loss or enforcing the note but leaving [redacted] without sufficient resources pay for the [redacted], has instead chosen to withhold collection activities. It is not bound to this choice, however.[7] In addition, the taxpayer was insolvent prior to and after all the modifications. It is unlikely that a court, in this situation, would hold that the taxpayer had realized taxable income. See, e.g., Mutual Loan and Savings Co., 184 F.2d 161. Further, the deferment of payment on the debt was in order to pay to clean-up a [redacted] contaminated site. Had the taxpayer chosen instead to pay its creditor, it could not have paid for the decontamination.

Because the debt was not forgiven but continues to be enforceable, because the taxpayer was insolvent and none of the modifications to the note were significant, the taxpayer has not realized any income from the alterations in obligor and collateral and from its default and the forbearance of collection activity by [redacted].

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[7] [redacted]'s motivation may be that it prefers [redacted] pay for the [redacted] since the environmental indemnity provided to it by [redacted] pursuant to the purchase agreement for [redacted]s stock may be ineffective. If so, [redacted] could be directly liable for clean-up costs.

If you have any questions, please contact Yvonne Peters at (619) 557-6014.

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